its additional section 263A costs, and thus, its historic absorption ratio for its first test period as if the rules prescribed in this section and §§1.263A–1 and 1.263A–2 had applied throughout the test period.

(vi) *Example.* The provisions of this paragraph (d)(4) are illustrated by the following example:

Example. (i) Taxpayer V uses the FIFO method of accounting for inventories and in 1994 elects to use the historic absorption ratio with the simplified resale method. After recomputing its additional section 263A costs in accordance with the transition rules of paragraph (d)(4)(v) of this section, V identifies the following costs incurred during the test period:

1991:
Add'l section 263A costs—$100
Section 471 costs—$3,000
1992:
Add'l section 263A costs—$200
Section 471 costs—$4,000
1993:
Add'l section 263A costs—$300
Section 471 costs—$5,000

(ii) Therefore, V computes a 5% historic absorption ratio determined as follows:

$$\text{Historic absorption ratio} = \frac{\$100 + 200 + 300}{\$3000 + 4{,}000 + 5{,}000} = \frac{\$600}{\$12{,}000} = 5\%$$

(iii) In 1994, V incurs $10,000 of section 471 costs of which $3,000 remain in inventory at the end of the year. Under the simplified resale method using a historic absorption ratio, V determines the additional section 263A costs allocable to its ending inventory by multiplying its historic ratio (5%) by the section 471 costs remaining in its ending inventory:

$$\text{Additional section 263A costs} = 5\% \times \$3{,}000 = \$150$$

(iv) To determine its ending inventory under section 263A, V adds the additional section 263A costs allocable to ending inventory to its section 471 costs remaining in ending inventory ($3,150=$150+$3,000). The balance of V's additional section 263A costs incurred during 1994 is taken into account in 1994 as part of V's cost of goods sold.

(v) V's qualifying period ends as of the close of its 1998 taxable year. Therefore, 1999 is a recomputation year in which V must compute its actual combined absorption ratio. V determines its actual absorption ratio for 1999 to be 5.25% and compares that ratio to its historic absorption ratio (5.0%). Therefore, V must continue to use its historic absorption ratio of 5.0% throughout an extended qualifying period, 1999 through 2004 (the recomputation year and the following five taxable years).

(vi) If, instead, V's actual combined absorption ratio for 1999 were not between 4.5% and 5.5%, V's qualifying period would end and V would be required to compute a new historic absorption ratio with reference to an updated test period of 1999, 2000, and 2001. Once V's historic absorption ratio is determined for the updated test period, it would be used for a new qualifying period beginning in 2002.

(5) *Additional simplified methods for resellers.* The Commissioner may prescribe additional elective simplified methods by revenue ruling or revenue procedure.

(e) *Cross reference.* See §1.6001–1(a) regarding the duty of taxpayers to keep such records as are sufficient to establish the amount of gross income, deductions, etc.

[T.D. 8482, 58 FR 42224, Aug. 9, 1993; 58 FR 47784, Sept. 10, 1993; 59 FR 3319, Jan. 21, 1994, as amended by T.D. 8559, 59 FR 39962, Aug. 5, 1994]

§1.263A–4 Rules for property produced in a farming trade or business. [Reserved]

§1.263A–4T Rules relating to property produced in a farming business.

(a)–(b) [Reserved]

(c) *Special rules for property produced in a farming business*—(1) *General rule.* In general, this section applies to property produced in a farming business if

such property has a preproductive period of more than 2 years, or if such farming business is described in paragraph (c)(2) of this section. This section does not apply, however, if the property is described in paragraph (c)(3) of this section or if the taxpayer has made the election described in paragraph (c)(6) of this section. In addition, this section does not apply to animals produced in a farming business if such animals are held primarily for slaughter (regardless of the preproductive period of such animals), except that this section shall apply to the production of such animals by a farming business if such business is described in paragraph (c)(2) of this section. For purposes of this section, an animal is held primarily for slaughter regardless of whether the taxpayer itself will slaughter the animal or instead will sell the animal to others for slaughter.

(2) *Taxpayers required to use the accrual method.* (i) This section applies to property produced in a farming business (including all animals held primarily for slaughter) without regard to the preproductive period of such property in the case of a:

(A) Corporation or partnership required to use an accrual method of accounting under section 447 in computing its taxable income from farming, or

(B) Tax shelter required to use an accrual method of accounting under section 448(a)(3).

Thus, for example, this section applies to an enterprise involving the feeding of cattle held for slaughter regardless of the preproductive period of such cattle, if the enterprise is required to use an accrual method of accounting under section 447 or section 448(a)(3).

(ii) For purposes of this section, a farming business shall be considered a tax shelter, and thus required to use an accrual method of accounting under section 448(a)(3), if that farming business is:

(A) A farming syndicate as defined in section 464(c); or

(B) A tax shelter within the meaning of section 6661(b)(2)(C)(ii), defined as—

(*1*) A partnership or other entity,

(*2*) Any investment plan or arrangement, or

(*3*) Any other plan or arrangement, if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax.

(iii) For purposes of this section, marketed arrangements in which persons carry on farming activities utilizing the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance if such persons prepay a substantial portion of their farming expenses with borrowed funds.

(3) *Exception*—(i) *In general.* This section does not apply to costs incurred on or after October 22, 1986, that are attributable to the replanting, cultivation, maintenance, and development of any plants bearing an edible crop for human consumption (including, but not limited to, plants which constitute a grove, orchard, or vineyard) that were lost or damaged while in the hands of the taxpayer by reason of freezing temperatures, disease, drought, pests, or casualty. Such replanting or maintenance costs may be incurred with respect to property other than the property on which the damage or loss occurred if the acreage of the property with respect to which the replanting or maintenance costs are incurred is not in excess of the acreage of the property on which the damage or loss occurred. Plants bearing crops for human consumption are those crops that are normally eaten or drunk by humans. Thus, for example, costs incurred with respect to replanting plants bearing jojoba beans do not qualify for the exception provided in this paragraph (c)(3)(i) because that crop is not normally eaten or drunk by humans.

(ii) *Ownership; in general.* Replanting, cultivation, maintenance, and development costs described in paragraph (c)(3)(i) of this section generally must be incurred by the taxpayer owning the property at the time the plants were lost or damaged. Paragraph (c)(3)(i) of this section will apply, however, to costs incurred by a person other than the taxpayer owning the plants at the time of damage or loss if—

(A) The taxpayer who owned the plants at the time the damage or loss occurred owns an equity interest of more than 50 percent in such plants or crops, and

(B) Such other person owns any portion of the remaining equity interest and materially participates in the replanting, cultivating, maintenance or development of such plants or crops.

A person will be treated as materially participating for purposes of this provision if such person would otherwise meet the requirements with respect to material participation within the meaning of section 2032A of the Code.

(4) *Definitions*—(i) *Farming business.* (A) For purposes of this section, a farming business means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples include the trade or business of operating a nursery or sod farm; the raising or harvesting of crops; the raising or harvesting of trees bearing fruit, nuts or other crops; the raising of ornamental trees; and the raising, shearing, feeding, caring for, training, and management of animals.

(B) For purposes of this section, an evergreen tree that is more than 6 years old at the time it is severed from its roots is not treated as an ornamental tree regardless of the purpose for which it is sold.

(C)(*1*) For purposes of this section, the term *farming business* does not include the processing of commodities or products beyond those activities which are normally incident to the growing, raising or harvesting of such products.

(*2*) Thus, for example, assume the taxpayer, a C corporation, is in the business of growing and harvesting wheat and other grains. The taxpayer processes grain that it has harvested in order to produce breads, cereals, and other similar food products, which it then sells to customers in the course of its business. Although the taxpayer is in the farming business with respect to the growing and harvesting of grain, the taxpayer is not in the farming business with respect to the processing of such grains to produce food products that it sells to customers.

(*3*) Similarly, assume the taxpayer is in the business of raising poultry or other livestock. The taxpayer then uses such livestock in a meat processing operation in which the livestock are slaughtered, processed, and packaged or canned in preparation for their sale to customers. Although the taxpayer is in the farming business with respect to the raising of livestock, the taxpayer is not in the farming business with respect to the meat processing operation.

(*4*) However, under this section the term *farming business* does include processing activities which are normally incident to the growing, raising of harvesting or agricultural products. For example, assume a taxpayer is in the business of growing fruits and vegetables. When the fruits and vegetables are ready to be harvested, the taxpayer picks, washes, inspects, and packages the fruits and vegetables for sale. Such activities are normally incident to the raising of these crops by farmers. The taxpayer will be considered to be in the business of farming with respect to the growing of fruits and vegetables, and the processing activities incident to their harvest.

(ii) *Preproductive period.* (A) For purposes of this section, the preproductive period of property produced in a farming business means—

(*1*) In the case of a plant or animal which will have more than one crop or yield, the period before the first marketable crop or yield from such plant or animal, or

(*2*) In the case of any other plant or animal, the period before such plant or animal is reasonably expected to be disposed of.

(B) The preproductive period of a plant begins when the plant or seed is first planted or acquired by the taxpayer. The preproductive period ends when the plant becomes productive in marketable quantities or when the plant is reasonably expected to be sold or otherwise disposed of.

(C) The preproductive period of an animal begins at the time of acquisition, breeding, or embryo implantation. The preproductive period ends at the time the animal is ready to perform the primary function intended to be performed by that animal (*e.g.,* when the animal becomes productive in marketable quantities), or when the animal is reasonably expected to be sold or otherwise disposed of. For example, in the case of a cow used for breeding purposes, the preproductive period with

respect to the cow ends on the date the first calf is dropped.

(D) The preproductive period of plants grown in commercial quantities in the United States shall be based on the weighted average preproductive period for such plant, determined on a nationwide basis.

(5) *Inventory methods*—(i) *In general.* Except as otherwise provided, the costs required to be allocated to any plant or animal under this section may be determined using reasonable inventory valuation methods such as the farm-price method or the unit-livestock-price method. See § 1.471–6.

(ii) *Availability to tax shelters.* Tax shelters, as defined in paragraph (c)(2)(i)(B) of this section, using the unit-livestock-price method of accounting for inventories must include in inventory the annual standard unit price for all animals which are acquired during the taxable year, regardless of whether such purchases are made during the last 6 months of the taxable year.

(iii) *Availability to property used in trade or business.* The farm-price method or the unit-livestock-price method may be used by any taxpayer to allocate costs to any plant or animal under this section, regardless of whether the plant or animal is held or treated as inventory property by the taxpayer. Thus, for example, a taxpayer may use the unit-livestock-price method to account for the costs of raising livestock which will be used in the trade or business of farming (e.g., a breeding animal or a dairy cow) although the property in question is not inventory property.

(6) *Election not to have this section apply*—(i) *Introduction.* This paragraph (c)(6) permits certain taxpayers to make an election not to have the rules of this section apply to any plant or animal produced in a farming business conducted by the electing taxpayer.

(ii) *Availability of the election.* The election described in this section is available to any farmer except that no election may be made by a corporation, partnership or tax shelter required to use an accrual method of accounting under section 447 or 448(a)(3). Moreover, no election may be made with respect to the planting, cultivation, maintenance or development of pistachio trees. In addition, the election described in this section does not apply to any costs incurred for the planting, cultivation, maintenance or development of any citrus or almond grove (or any part thereof) to the extent that such costs are incurred within the first four years in which such trees were planted. If a citrus or almond grove is planted in more than one taxable year, the portion of the grove planted in any one taxable year is treated as a separate grove for purposes of determining the year of planting.

(iii) *Time and manner of making the election.* Unless consent is obtained from the Commissioner, the election described in this section may only be made for the taxpayer's first taxable year that begins after December 31, 1986, and during which the taxpayer engages in a farming business. The election shall be made on the schedule E, F, or other schedule required to be attached to the income tax return for the first taxable year for which the election is effective. In the case of a partnership or S corporation, the election must be made by the partner or shareholder.

(iv) *Election treated as if made if certain requirements satisfied.* A taxpayer eligible to make the election under paragraph (c)(6) of this section shall be treated as having made the election if such taxpayer does not capitalize the costs of producing property in a farming business as the provisions of this section would otherwise require.

(v) *Revocation.* Once the election is made, it is revocable only with the consent of the Commissioner.

(vi) *Special rules for treatment of expenses.* (A) If the election is made, the plant or animal produced by the taxpayer is treated as section 1245 property and any gain resulting from any disposition of such property is recaptured (*i.e.,* treated as ordinary income) to the extent of the total amount of the deductions which, but for the election, would have been required to be capitalized with respect to the plant or animal. In calculating the amount of gain which is recaptured under this paragraph (c)(6)(vi), the taxpayer may use the farm-price or unit-livestock methods in determining the deductions

which otherwise would have been capitalized with respect to the plant or animal.

(B) If the taxpayer or a related person makes the election, the alternative depreciation system (as defined in section 168(g)(2)), shall be applied to all property used predominantly in any farming business of the taxpayer or related person and placed in service in any taxable year during which the election is in effect. The requirement to use the alternative depreciation system by reason of any election under paragraph (c)(6) of this section shall not prevent any taxpayer from making an election under section 179 to expense certain depreciable business assets.

(C) For purposes of this paragraph (c)(6), the term *related party* means—

(*1*) The taxpayer and members of the taxpayer's family (defined, for this purpose, to include the spouse of the taxpayer and any of his or her children who have not reached the age of 18 as of the last day of the taxable year in question),

(*2*) Any corporation (including an S corporation) if 50 percent or more of the stock (in value) is owned directly or indirectly (through the application of section 318) by the taxpayer or members of the taxpayer's family,

(*3*) A corporation and any other corporation which is a member of the same controlled group (within the meaning of section 1563(a)(1)), and,

(*4*) Any partnership if 50 percent or more (in value) of the interests in such partnership is owned directly or indirectly (through the application of section 318) by the taxpayer or members of the taxpayer's family.

(vii) The operation of the election not to have this section apply is illustrated in the following examples:

Example (1) Assume that A, an individual, is engaged in the trade or business of farming. A raises cattle for breeding and dairy purposes. In addition, A grows and harvests wheat and other grains. Assume further, that the preproductive period of certain of the cattle raised by A is more than two years, as defined in paragraph (c)(4)(ii) of this section, and that A elects under paragraph (c)(6) of this section not to have the rules of this section apply to the costs of raising such cattle. A is required to use the alternative depreciation system described in section 168(g) of the Code with respect to all property used predominantly in any farming business of A (including the growing and harvesting of wheat) if such property is placed in service during a year for which the election is in effect. Thus, for example, all assets and equipment (including any dairy cattle which A treats as depreciable property, and any equipment used to grow and harvest wheat) placed in service during a year for which the election is in effect must be depreciated using the straight line method over the applicable number of years, as provided in section 168(g).

Example (2) Assume the same facts as in *Example 1*, except that A and members of A's family (as defined in paragraph (c)(6)(vi)(C)) also own 51% (in value) of the interests in a partnership P, which is engaged in the trade or business of growing and harvesting corn. P is a related person to A under the provisions of paragraph (c)(6)(i)(F) of this section. Thus, the requirements to use the alternative depreciation system under section 168(g) also apply to any property used predominantly in a trade or business of farming which P places in service during a year for which the election made by A is in effect.

(d) This section is effective for costs incurred after December 31, 1986, in taxable years ending after such date. In the case of property that is inventory in the hands of the taxpayer, this section is effective for taxable years beginning after December 31, 1986.

[T.D. 8131, 52 FR 10060, Mar. 30, 1987, as amended by T.D. 8148, 52 FR 29378, Aug. 7, 1987. Redesignated and amended by T.D. 8559, 59 FR 39960, Aug. 5, 1994]

§ 1.263A–5 Exception for qualified creative expenses incurred by certain free-lance authors, photographers, and artists. [Reserved]

§ 1.263A–6 Rules for foreign persons. [Reserved]

§ 1.263A–7 [Reserved]

§ 1.263A–7T Rules relating to changes in methods of accounting.

(a)–(d) [Reserved]

(e) *Inventories*—(1) *In general.* (i) Under section 263A and the regulations thereunder, taxpayers are required to change their method of accounting with respect to inventory property, effective for taxable years beginning after December 31, 1986. The required change in method of accounting applies to inventory produced by the taxpayer, as well as to inventory acquired by the

taxpayer for resale. The change in method of accounting is to be made by revaluing the items or costs included in beginning inventory in the year of change as if the new capitalization rules of section 263A and the regulations thereunder had been in effect during all prior periods. In revaluing inventory costs under this procedure, all of the capitalization provisions of section 263A and the regulations thereunder (*e.g.*, the requirement to capitalize the entire amount of tax depreciation and cost recovery allowances with respect to equipment and facilities and the repeal of the practical capacity concept), shall apply to all inventory costs accumulated in prior periods. The necessity to revalue beginning inventory as if the new capitalization rules had been in effect for all prior periods includes, for example, the revaluation of costs or layers incurred in taxable years preceding the transition period to the full absorption method of inventory costing as described in §1.471–11(e), regardless of whether a taxpayer employed a ''cut-off'' method under those regulations. The difference between the inventory as originally valued and the inventory as revalued by applying the new capitalization rules is equal to the amount of the adjustment required under section 481(a). For example, with respect to inventories of films, sound recordings, video tapes, books, and other similar property, the taxpayer shall revalue the costs of such items under the principles of this paragraph (e)(1).

(ii) Pursuant to the change in method of accounting required under section 263A and the regulations thereunder, taxpayers are required to revalue the amount of deferred gain or loss resulting from the sale or exchange of inventory property in an intercompany transaction, to an amount equal to the deferred gain or loss that would have resulted had the cost of goods sold for that inventory property been determined under the capitalization rules of section 263A and the regulations thereunder. The requirement of the preceding sentence shall apply with respect to both property produced by the taxpayer, or property acquired by the taxpayer for resale. In addition, the requirements of this paragraph shall apply only to the deferred gain or loss of the taxpayer as of the beginning of the year of change in method of accounting required under section 263A and the regulations thereunder. (See §1.1502–13, which separately requires that the capitalization rules of section 263A and the regulations thereunder shall apply in determining the cost of goods sold for intercompany transactions occurring after the effective date of section 263A.) Corresponding changes to the adjustment required under section 481(a) shall be made with respect to any adjustment of the deferred gain or loss required under this paragraph. Moreover, the requirements of this paragraph shall apply regardless of whether the taxpayer has any items in beginning inventory as of the year of change in method of accounting. The terms *deferred gain or loss* and *intercompany transaction* as used herein are as used in §1.1502–13.

(iii) The provisions of paragraph (e)(1)(ii) of this section are illustrated by the following example.

(A) *Example.* Assume that corporation A, a member of an affiliated group of corporations filing a consolidated federal income tax return on a calendar year, manufactures and sells inventory property to corporation B, a member of the same affiliated group, in 1985. The gain from the sale of the inventory property is deferred by A under §1.1502–13 of the regulations. As of the beginning of the year of change in method of accounting (January 1, 1987), the inventory property is still held by corporation B based on the particular inventory method of accounting used by B for Federal income tax purposes (e.g., LIFO or FIFO). The property was sold by A to B in 1985 for $150; the cost of goods sold with respect to the property under the law in effect at the time the inventory was produced (see §1.471–3) was $100, resulting in a gain of $50 which A deferred under §1.1502–13. The deferred intercompany gain as of January 1, 1987, with respect to the transaction, is $50.

(B) Under section 263A and the regulations thereunder, A is required to revalue the amount of deferred intercompany gain resulting from the sale of the inventory property to an amount equal to the deferred gain which would have resulted had the cost of goods sold for that inventory property been determined under the capitalization rules. Assume that the cost of the inventory under the capitalization rules would have been $110, had the capitalization rules applied to A's manufacture of the property in 1985. Thus, A is required to revalue the amount of

deferred gain to $40 (i.e., $150 less $110), necessitating a negative adjustment to the deferred gain of $10. Moreover, A is required to increase its section 481(a) adjustment by $10 in order to prevent the omission of such amount by virtue of the decrease in the deferred intercompany gain.

(iv) In determining the amount of intercompany gain which would have resulted had the cost of goods sold for that inventory property been determined under the capitalization rules of section 263A and the regulations thereunder, a taxpayer may use the other methods and procedures otherwise properly available to that particular taxpayer in revaluing inventory under section 263A and the regulations thereunder, including, if appropriate, the various simplified methods provided in section 263A and the regulations thereunder and the various procedures described in paragraph (e) of this section.

(2) *Section 481(a) adjustment.* In the case of any taxpayer required by section 263A and the regulations thereunder to change its method of accounting for any taxable year, such change shall be treated as initiated by the taxpayer. (In addition, such change shall be treated as made with the consent of the Commissioner, subject to the provisions of paragraph (e)(11) of this section). Thus, for example, the adjustment required under section 481(a) with respect to the change in method of accounting for such taxpayer shall not be reduced in any manner by any amount pertaining to taxable years preceding the effective date of the Internal Revenue Code of 1954. The adjustment arising from the change in method of accounting is to be taken into account over a period not to exceed 4 years.

(3) *Timing of section 481(a) adjustment.* (i) Any taxpayer required to change its method of accounting under section 263A and the regulations thereunder shall take into account the adjustment required under the administrative procedures applicable to a voluntary change in method of accounting in effect on January 1, 1987, subject to the following modifications:

(ii) If 75 percent or more of the section 481(a) adjustment is attributable to the 1-taxable year period, 2-taxable year period, or 3-taxable year period immediately preceding the year of change, the highest percent attributable to the 1, 2, or 3-taxable year period is to be taken into account ratably over a 3-taxable year period beginning with the year of change. The remaining balance is to be taken into account in the 4th taxable year (the ''75 percent rule''). The 75 percent rule of this paragraph shall only apply if the taxpayer has used its present method of accounting for more than 3 taxable years.

(iii) If paragraph (e)(3)(ii) of this section does not apply, the section 481(a) adjustment is to be taken into account ratably over the number of tax years (not to exceed 4) that the taxpayer has engaged in the particular trade or business of producing property or acquiring property for resale to which the adjustment applies.

(iv) If the taxpayer is a cooperative within the meaning of section 1381(a), the section 481(a) adjustment may be taken into account entirely in the year of change or, at the taxpayer's election, may be taken into account under the general procedures applicable to other taxpayers, as modified by the rules of this paragraph.

(v) The use of the expedited procedure described in pargraph (e)(4) of this section may be elected by a taxpayer in applying the 75 percent rule described in paragraph (e)(3)(ii) of this section.

(vi) Any net operating loss and tax credit carryforwards will be allowed to offset any positive section 481(a) adjustment.

(vii) For purposes of determining estimated tax payments, the section 481(a) adjustment will be recognized in taxable income ratably throughout the year in question.

(4) *Expedited procedure for applying the 75-percent rule*—(i) *In general.* Any taxpayer required to change its method of accounting under section 263A and the regulations thereunder may elect to use the expedited procedure of this paragraph (e)(4)(i) in determining the appropriate period for taking into account the section 481(a) adjustment under the provisions of the 75-percent rule contained in paragraph (e)(3)(ii) of this section. Under the 75-percent rule, the period for taking the section 481(a) adjustment into account may be accelerated if 75 percent or more or the adjustment is attributable to either the 1-taxable year period, 2-taxable year